

Magic of Compounding

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Summary – Compounding works wonders for your wealth. Once you understand it and implement it, you will be able to make a substantial amount of money. To maximise the compounding effect, you should start early, stay invested for a long term and be disciplined enough to not to take out money from the money being compounded.

You have two options with you -

- You will get Rs. 1000 per day for 30 days.
- You will get Re. 1 today which will double in value every day for 30 days.

Which one will you choose?

At the end of 30 days, the first option will give you Rs. 30000.

The second option will give you Rs. 53,68,70,912

The second option does not seem lucrative in the short-term, but over a longer period of time, the magic of compounding kicks in and you will be able to see the benefits.

In the illustration below, you can see that if your friend got the same Re. 1 that doubled in value 15 days after you got it, there is a big difference. The total amount he/ she would have had on the same date is Rs. 16384! 15 days made such a huge difference.

Days	Amount Received by You	Amount Received by your Friend
1	1	
2	2	
3	4	
4	8	
5	16	
6	32	
7	64	
8	128	
9	256	
10	512	
11	1024	
12	2048	
13	4096	
14	8192	
15	16384	
16	32768	1
17	65536	2
18	131072	4
19	262144	8
20	524288	16
21	1048576	32
22	2097152	64
23	4194304	128
24	8388608	256
25	16777216	512
26	33554432	1024
27	67108864	2048
28	134217728	4096
29	268435456	8192
30	536870912	16384

How does the magic of compounding work?

There are two aspects to it -

1. Money works on its own on the money you earn. Even if you save a small amount, you start earning on what you keep saving and what you have earned before. This example will show us how it happens -

I put Rs. 1000 in my bank account and earn 5% interest per year. It means at the end of the year, I will get 5% on Rs. 1000 which is Rs. 50. So the total balance in my account will be Rs. 1050 (1000+50). If I leave this money untouched and do not even deposit more money in the account, at the end of the second year, I will earn 5% on Rs. 1050 which is Rs. 52.50 (more than what I earned in the first year). Let us see what happens if I continue this.

Year	Amount Invested	Interest Earned	Total Sum
1	1000.00	50.00	1050.00
2	1050.00	52.50	1102.50
3	1102.50	55.13	1157.63
4	1157.63	57.88	1215.51
5	1215.51	60.78	1276.28
6	1276.28	63.81	1340.10
7	1340.10	67.00	1407.10
8	1407.10	70.36	1477.46
9	1477.46	73.87	1551.33
10	1551.33	77.57	1628.89
11	1628.89	81.44	1710.34
12	1710.34	85.52	1795.86
13	1795.86	89.79	1885.65
14	1885.65	94.28	1979.93
15	1979.93	99.00	2078.93
16	2078.93	103.95	2182.87
17	2182.87	109.14	2292.02
18	2292.02	114.60	2406.62
19	2406.62	120.33	2526.95
20	2526.95	126.35	2653.30

As you can see, your money has doubled in 15 years without you doing much.

2. The earlier you make your money work, the more money you will have just like in the example above how 15 days made such a huge difference in the total amount earned. It is therefore important to start saving earlier. The earlier you start saving, the more money you will have.

Compounding is like magic. It is easy and helps you save a lot of money. But you need to be disciplined about it.

Compounding is an integral part of financial planning. It is important for savings and investments. A person should start saving and investing as early as possible. This will help in bigger savings in the future. Typically, investments made today even with smaller amounts will give more returns in the long run compared to investments made 3 years down the line. You should start investing when you have little money as well and not wait for a lump sum amount to start investing.

The same happens in the case of spending. Suppose you spend Rs. 20 on a soft drink every day. In one year, you would have spent Rs. 7300. You eroded your savings and anyways having a soft drink everyday is not a smart thing from a health perspective.

What should you remember about compounding -

- Earlier you start, the better
- Choose the shortest compounding period possible so that the money works for you more number of times.
- Compounding works on saving and spending. Take care of your spending so that they do not spiral out of control.
- Do not take out from the pool of money that is getting compounded, as the magic will not work effectively then.